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Required communication of material weaknesses in internal accounting control; Statement on auditing standards, 020

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

Statement on Auditing Standards

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20

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AICPA American Institute of Certified Public Accountants

Required Communication of Material Weaknesses in Internal Accounting Control[1]

1. This Statement establishes a requirement that the auditor communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control[2] that come to his attention during an examination of financial statements made in accordance with generally accepted auditing standards.[3] Except for certain modifications to the form of report,

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[1] This Statement amends SAS No. 1, section 640.01, and SAS No. 1, section 320.68, by the addition of the following sentence:

> If the auditor is aware of a material weakness in internal accounting control, whether or not he is specifically engaged by the client to review and report on the system of internal accounting control, a communication as described in SAS No. 20, "Required Communication of Material Weaknesses in Internal Accounting Control," is required.

This Statement also revises sections 640.12 and 640.13 of SAS No. 1. See Appendix for revised wording.

[2] A material weakness in internal accounting control is defined in SAS No. 1, section 320.68, as "a condition in which the auditor believes the prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions."

[3] See also SAS No. 10, "Limited Review of Interim Financial Statements," which states: "If the system of internal accounting control appears to contain weaknesses that do not permit preparation of interim financial information in conformity with generally accepted accounting principles, and, as a consequence, it is impracticable for the accountant to effectively apply his knowledge of financial reporting practices to the interim financial information, he should advise the board of directors of the circumstances."

this Statement does not address the subject of reporting to the public (investors and others who rely on published financial information) on a company's system of internal accounting control. Reports to the public on material weaknesses in the system are permitted by section 640 of SAS No. 1. The Committee is continuing its consideration of the significant underlying issues of other forms of reporting to the public on a system of internal accounting control.

2. The existence of material weaknesses in internal accounting control affects the nature, extent, and timing of audit tests to be applied in an examination of financial statements. However, the communication, either orally or in a written report, of such weaknesses of which the auditor is aware is not required to enable the auditor to state that his examination has been made in accordance with generally accepted auditing standards. Rather, the communication of material weaknesses in internal accounting control is incident to the auditor's objective in making an examination of financial statements, which is to form an opinion as to whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles consistently applied. Such communication is also incident to the purposes of the auditor's study and evaluation of the system of internal accounting control, which are to establish a basis for reliance thereon and for determination of the resultant extent of the tests to which auditing procedures are to be restricted and to assist him in planning and performing his examination of the financial statements.

3. The auditor may become aware of material weaknesses in internal accounting control through his initial review of the system. This review is primarily a process of obtaining information about the organization and the procedures prescribed and is intended to serve as a basis for making a preliminary evaluation of the system. If the auditor intends to rely on the prescribed procedures, the review will also serve as a basis for designing related tests of compliance that are intended to provide reasonable assurance that the accounting control procedures are being applied as prescribed. The auditor may also become aware of material weaknesses in internal accounting control by performing such tests of compliance with prescribed procedures. Further, the auditor may become aware of

material weaknesses in internal accounting control by performing substantive tests the purpose of which is to obtain evidence as to the validity and propriety of the accounting treatment of transactions and balances or, conversely, of errors or irregularities therein.[4] However, there is no requirement under generally accepted auditing standards to evaluate each control or to identify every material weakness. Also, the auditor may decide not to test compliance with prescribed procedures relating to all or certain elements of the system because the audit effort required to test compliance exceeds the reduction in audit effort that could be achieved by reliance on the system. The auditor's examination is based on the concept of testing selected items and, thus, is subject to the inherent risk that all material weaknesses in internal accounting control will not be disclosed.

4. Establishing and maintaining a system of internal accounting control is management's responsibility. Knowledge of material weaknesses in internal accounting control is essential for management to discharge this responsibility by instituting corrective action as necessary in the circumstances. Procedures by which management may obtain knowledge of such weaknesses include, but are not limited to, periodic discussions with other levels of management with respect to weaknesses that come to their attention, reports of internal auditors, and communications from the independent auditor. Consequently, the independent auditor should communicate to senior management and to the board of directors or its audit committee (or the equivalent level of authority, such as a board of trustees) any material weaknesses that come to his attention during the course of his examination of the financial statements if such weaknesses have not been corrected before they come to his attention. Preferably, the auditor's findings should be communicated in a written report to reduce the possibility of misunderstanding. If the auditor's findings are communicated orally, he should document the communication by appropriate notations in his audit working papers.

5. The auditor should communicate material weaknesses in internal accounting control that he becomes aware of through his

[4] For a discussion of the review of the system of internal accounting control, tests of compliance, and substantive tests, see SAS No. 1, sections 320.49–.75.

examination of the financial statements at the earliest practicable date following the completion of his examination. Because of the possible effects of the material weaknesses, the auditor should consider communicating material weaknesses at interim dates after carrying out parts of the examination. When more than one communication is made in connection with an examination, it is not necessary for the auditor to repeat weaknesses reported at interim dates in his final communication, provided he makes reference to the interim communication(s).

6. If the auditor does not become aware of any material weaknesses in internal accounting control during his examination of the financial statements, he may, but is not required to, communicate that fact.

7. The auditor's concern for material weaknesses in internal accounting control previously communicated in connection with an examination of prior financial statements is limited to his consideration of such weaknesses and the corrective action taken, if any, as they affect his study and evaluation of internal control in connection with his current examination. If such previously reported weaknesses have not been corrected, the auditor should either repeat them in his communication relating to the current examination, or refer to previous communications.

8. The form of communication is optional. A suggested form of an auditor's written report follows.

> We have examined the financial statements of ABC Company for the year ended December 31, 19X1, and have issued our report thereon dated February 23, 19X2.[5] As a part of our examination, we made a study and evaluation of the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards, the purposes of such evaluation are to establish a basis for reliance on the system of internal accounting control in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements and to assist the auditor in planning and per-

[5] If the report on an examination of the financial statements is qualified because of a restriction on the scope of the examination, the restriction and its effect on the evaluation of the system of internal accounting control should be indicated in the report thereon.

forming his examination of the financial statements. (If the auditor believes that the description of the objective of internal accounting control and the inherent limitations of any system, which are set forth in the illustrative report in section 640.12 of SAS No. 1, would be informative to the reader of his written report, he may wish to include them here or in an appendix to the report. Sections 640.12 and 640.13 of SAS No. 1 as revised by this Statement are reproduced in the Appendix to this Statement.)

Our examination of the financial statements made in accordance with generally accepted auditing standards, including the study and evaluation of the Company's system of internal accounting control for the year ended December 31, 19X1, that was made for the purposes set forth in the first paragraph above, would not necessarily disclose all weaknesses in the system because it was based on selective tests of accounting records and related data. However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses, excluding those which were corrected before they came to our attention. (A description of the material weaknesses that have come to the auditor's attention would follow.)

The foregoing conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the financial statements, and this report of such conditions does not modify our report dated February 23, 19X2, on such financial statements.

9. If the auditor becomes aware of material weaknesses for which management believes corrective action is not practicable, he may refer to the circumstances and summarize the weaknesses; a detailed communication of the circumstances and related weaknesses is not required. When a written report is issued, the related sentence would state: "However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses for which management believes corrective action is not practicable in the circumstances." The auditor would then summarize the weaknesses and describe the circumstances (for example, inadequate control over cash transactions because of inadequate segregation of duties due to limited personnel).

10. The communication of material weaknesses in internal accounting control may include comments concerning corrective action taken or in process. The auditor may also offer suggested corrective action with respect to material weaknesses in internal accounting control for management's consideration. However, any additional

study made to develop constructive suggestions is not part of an examination of financial statements made in accordance with generally accepted auditing standards. The auditor may also wish to communicate immaterial weaknesses in internal accounting control but is not required to do so.

11. Statements on Auditing Standards generally are effective at the time of their issuance. However, since this Statement provides for practices that may differ in certain respects from practices heretofore considered acceptable, this Statement will be effective for examinations of financial statements for periods ending on or after December 24, 1977.

Appendix

Sections 640.12 and 640.13 of SAS No. 1 are amended to read as follows:

Form for Reports on Internal Control Based on Audits

.12 If reports on auditors' evaluations of internal accounting control are to be issued, the risk of misunderstanding can be reduced by adopting a form of report that describes in reasonable detail the objective and limitations of internal accounting control and the auditor's evaluation of it. Therefore, the following language should be used for such purpose except as discussed in the subsequent paragraphs in this section.

> We have examined the financial statements of ABC Company for the year ended December 31, 19X1, and have issued our report thereon dated February 23, 19X2.[1] As a part of our examination, we made a study and evaluation of the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards, the purposes of such evaluation are to establish a basis for reliance on the system of internal accounting control in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements and to assist the auditor in planning and performing his examination of the financial statements.
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> The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.
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> There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures

[1] If the report on an examination of the financial statements is qualified because of a restriction on the scope of the examination, the restriction and its effect on the evaluation of the system of internal accounting control should be indicated in the report thereon.

whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management either with respect to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.

Our examination of the financial statements made in accordance with generally accepted auditing standards, including the study and evaluation of the Company's system of internal accounting control for the year ended December 31, 19X1, that was made for the purposes set forth in the first paragraph of this report, would not necessarily disclose all weaknesses in the system because it was based on selective tests of accounting records and related data. However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses. (A description of the material weaknesses that have come to the auditor's attention would follow.)

The foregoing conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the financial statements, and this report of such conditions does not modify our report dated February 23, 19X2, on such financial statements.

The description of material weaknesses should indicate whether the weaknesses relate to the prescribed procedures or to compliance with them. The report may also include recommendations for improvements, comments concerning corrective action taken or in process, or other comments appropriate in the circumstances. The basis for any comments concerning subsequent corrective action should be indicated, including the scope of any review and tests by the auditor. Although the first and fifth paragraphs of the foregoing form of report clearly indicate that weaknesses in the system are considered in determining the nature, timing, and extent of auditing procedures necessary for expressing an opinion on financial statements, some auditors may want to include further comments in this respect.

.13 In some cases, the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances and he may decide to exclude such weaknesses from his report.[2]

[2] If the auditor is aware of a material weakness, it should be communicated to management, whether or not corrective action is practicable (see SAS No. 20, "Required Communication of Material Weaknesses in Internal Accounting Control").

If such weaknesses are excluded, the last sentence of the fourth paragraph of the above form of report should be modified as follows:

> However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses for which corrective action by management may be practicable in the circumstances.

Such a report should include appropriate description of material weaknesses for which the auditor has either (1) concluded that corrective action by management is practicable or (2) formed no conclusion in this respect.

The Statement entitled Required Communication of Material Weaknesses in Internal Accounting Control *was adopted by the assenting votes of seventeen members of the Committee, of whom three, Messrs. Grifferty, Konkel, and Solomon, assented with qualifications. Messrs. Groveman, Hepp, and Martin dissented.*

Mr. Grifferty approves the issuance of this Statement, but qualifies his assent with respect to paragraph 4 because he believes that the requirement to communicate material weaknesses is virtually inoperative in broad application since, in his view, existing authoritative auditing literature does not provide guidance sufficient for the auditor to measure objectively and uniformly the materiality of weaknesses in systems of internal accounting control. Further, even if such guidance existed, Mr. Grifferty believes that it is redundant and purposeless for the auditor to communicate to senior management and to the board of directors or its audit committee internal control weaknesses of which they are already aware. Accordingly, it is his view that the direction of this paragraph should be to encourage the auditor, as a matter of good professional practice, to be satisfied that management, at the appropriate levels, is aware of all but insignificant weaknesses in internal control that come to the auditor's attention during the course of his examination.

Messrs. Konkel and Solomon approve issuance of this Statement but qualify their assent with respect to paragraph 4. They believe that the Statement should require communication of material weaknesses to be in writing. They believe that the possibility of misunderstanding between the client and the auditor is increased, and that the effect of this Statement is substantially weakened, by permitting oral communication of material weaknesses as an alternative.

Mr. Groveman dissents to the issuance of this Statement because he believes it adds further confusion to a much misunderstood subject, while adding little to improve present practice. For example, he believes this Statement imposes on the auditor an obligation to report ("communicate"—since he may do so orally) that which he has no obligation to find, because his obligation to review internal accounting control exists only for the purpose of determining the extent of his audit tests, and "material weaknesses in internal accounting control" are defined solely within such context. Moreover, he believes readers may misunderstand the Statement and conclude that auditors must do additional work to identify material weaknesses in internal accounting control. Therefore, he is concerned that, among other matters, the Statement may result in auditors' doing additional work which many of their clients have not requested and do not find necessary. In particular, he thinks that many smaller or closely held businesses will see little value in their auditor's performing additional work so that he might inform them of material weaknesses that are not practicable to correct or that he had called to their attention in a prior year.

Mr. Groveman also believes that the subject of reporting to the public on a company's system of internal accounting control is the issue of immediate concern and that this Statement not only does not address this issue, but, notwithstanding the comments in paragraph 1, the public may not understand how or why the communication required by this Statement should be distinguished from a report to the public on internal accounting control.

Mr. Hepp dissents to the issuance of this Statement because he disagrees with the requirement that the auditor communicate to senior management and to the board of directors or its audit committee material weaknesses in internal accounting control that come to his attention during his examination, since paragraph 2 states that the absence of such communication has no effect upon an auditor's representation that his examination has been performed in accordance with generally accepted auditing standards. Further, although Mr. Hepp agrees that communications regarding internal accounting control matters may benefit management in many situations, he believes that the auditor should be permitted to make practical judgments in deciding when such communications should be made and the extent thereof. For example, he believes such judgments should be permitted when management informs the auditor that such communications are not desired, or when the auditor performs examinations of financial statements of small, closely held businesses, because such businesses operate in a totally different economic environment from large or publicly held companies. Also, Mr. Hepp believes that such judgments should be permitted with respect to material weaknesses for which management believes corrective action is not practicable. He notes that such judgments are permitted by section 640.13 of SAS No. 1 when reports on internal control are available to third parties.

Mr. Martin dissents to the issuance of this Statement because he believes that it is not appropriate to establish a requirement to communicate material weaknesses in internal accounting control when, as paragraph 2 states, such communication is incident to the auditor's objective in making an examination of financial statements. Mr. Martin also observes that the Statement does not provide a uniform approach or objective criteria for the identification of material weaknesses. Accordingly, he believes that any required communication will be misunderstood as to its foundation and completeness. He also believes that it is not appropriate to require a communication only to senior management and to the board of directors or its audit committee on this subject, which has received much public attention, until the Committee has completed its consideration of the significant underlying issues of reporting on systems of internal accounting control.

Mr. Martin also objects to the imposition of the requirements of this Statement on the auditor of the smaller business whose management may not be able to correct material weaknesses because of the nature or size of the business. Further, he finds it incongruous to impose a requirement to communicate material weaknesses and then permit the required communication to be made orally. He agrees with Messrs. Konkel and Solomon that the Statement should require communication of material weaknesses to be in writing.

Auditing Standards Executive Committee (1976-1977)

Note: *Statements on Auditing Standards are issued by the Auditing Standards Executive Committee, the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Ethics requires adherence to the applicable generally accepted auditing standards promulgated by the Institute. It recognizes Statements on Auditing Standards as interpretations of generally accepted auditing standards and requires that members be prepared to justify departures from such Statements.*